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Backgrounder

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# Taxing Investments:

## *On the Right Track, But at a Snail's Pace*

Duanjie Chen
and Jack M. Mintz

**The Backgrounder in Brief**

*Governments in Canada are moving in the right direction by reducing corporate taxes. Why are they taking so long?*

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In response to many requests, we are writing this *Backgrounder* in order to update our earlier paper[1] by incorporating recent federal and provincial tax changes announced in the 2003 budgetary period. We have benefited from some new data that updates our calculations of effective tax rates on capital, incorporating corporate income, capital and sales taxes on capital.[2]

Federal and provincial 2003 budgets are reducing taxes on investment. These policies are welcome because lower corporate taxes will make Canada more attractive for the kind of investment that is vital for job creation and for raising the incomes of workers. The tax reductions will bring Canada's effective tax rates on capital closer to those prevailing in the United States by 2008.

However, wide variation in federal-provincial effective tax rates will remain in Canada by 2008. Manitoba and Saskatchewan investments are the most highly taxed while Alberta and Newfoundland are the least taxed. Ontario will have the third highest tax rate on capital should the province rescind its corporate tax cuts.

Sadly, the changes take effect over too long a period. The U.S. is contemplating significant tax reform, as recently seen with the 2003 Bush amendments that reduce the tax on dividends and hasten accelerated depreciation. The competitiveness of the U.S. corporate tax system is a concern to the Administration and Congress because effective tax rates on capital — even though lower than Canada's — are higher than those in many other countries.[3]

Meanwhile, Canada is squandering an almost $9-billion annual improvement in our standard of living by stretching the tax cuts over five years rather than implementing them quickly. Governments are constraining their tax cutting because of excessive, and often needlessly lavish, expenditure commitments. The corporate tax cuts they are planning are relatively modest and, had the spending increases pledged by governments — as high as 11 per cent at the federal level in the recent budget — been held to lower levels, the reductions could be implemented soon without throwing budget balances out of whack.

Governments could also help pay for business tax cuts by eliminating some of the inefficient incentives that undermine Canada's productivity The tax base remains riddled with special preferences, many of them ineffective in achieving objectives.

## The 2003 Budget Tax Reductions

The federal government is phasing in the elimination of the relatively large corporations tax (a tax on capital) from 2004-to-2008. The federal general corporate income tax rate will be reduced a further two percentage points in 2004 from 23 percent to 21 percent, eliminating the difference between manufacturing and processing and other sectors. The federal government also proposed a package

1 See D. Chen and J. Mintz, 2003.

2 We thank the Department of Finance, Ottawa, for providing us with new information on capital stock weights, economic depreciation rates for assets and some other data used in our model at the Institute of International Business, University of Toronto.

3 For an illustration, see Chen and Mintz 2003 — U.S. effective tax rates on capital are higher than those in many European countries including Ireland, Sweden and Britain.

**Table 1: Corporate Income and Capital Tax Rates by Province for 2003 and 2008**

| | General Corporate Income Tax Rate 2003* | General Corporate Income Tax Rate 2008 | Capital Tax Rate 2003 | Capital Tax Rate 2008 |
|---|---|---|---|---|
| | | (%) | | |
| British Columbia | 13.5 | 13.5 | 0.0 | 0.0 |
| Alberta | 12.5 | 11.5 | 0.0 | 0.0 |
| Saskatchewan | 17.0 | 17.0 | 0.6 | 0.6 |
| Manitoba | 16.0 | 15.0 | 0.5 | 0.5 |
| Ontario | 12.5 | 8.0 | 0.3 | 0.27 |
| Quebec | 8.9 | 8.9 | 0.6 | 0.6 |
| New Brunswick | 13.0 | 13.0 | 0.3 | 0.3 |
| Nova Scotia | 16.0 | 16.0 | 0.25 | 0.0 |
| PEI | 16.0 | 16.0 | 0.0 | 0.0 |
| Newfoundland | 14.0 | 14.0 | 0.0 | 0.0 |
| *Federal* | *24.12* | *22.12* | *0.225* | *0.0* |

* Including surtax.

that will result in a multi-year phased-in reduction in corporate income tax rates on resource profits from 28 percent to 21 percent, coupled with a replacement of the resource allowance by deductibility of resource royalties and a 10-percent tax credit for exploration.

Some provinces, including Alberta, Manitoba, Ontario and Nova Scotia, are also reducing corporate tax rates:

- Ontario legislated reductions in corporate income tax rates to 8 percent by 2006 from the current 12.5 percent (11 percent for manufacturing). The province has also announced a 10-percent reduction in capital taxes for 2004, with the intention of eliminating the capital tax by 2008, although the abolition has not yet reached the legislative stage.
- Alberta is reducing its corporate income tax rate this year to 11.5 percent, with the intention of lowering the corporate income tax rate to 8 percent if that does not overshoot the budget.
- Manitoba will lower its corporate income tax rate to 15 percent by 2005 from the current 16 percent.
- Nova Scotia is eliminating its capital tax altogether.

Table 1 provides the statutory corporate income and capital tax rates in 2003 and those that are expected to prevail by 2008, according to legislation.

## On the Way to Competitive Tax Rates in North America

The phased-in reductions in corporate taxes will help boost investment in Canada. Taxes reduce the return earned by businesses on investments; lowering them will help improve the climate for investment.[4] To capture the impact of taxes on

4 Estimates vary about how much corporate taxes affect investment. Typical results suggest that a 10-percent decline in the tax-adjusted cost of capital will increase capital stock by amounts ranging from 5-to-20 percent after some years. See Mintz (1995) for a review of studies.

**Table 2: Effective Corporate Tax Rates on Capital for Large Corporations: 2003 and 2008**

| | Canada 2003 | Canada 2008 | United States 2003 | United States No Accelerated Depreciation |
|---|---|---|---|---|
| | | | (%) | |
| Forestry | 30.1 | 26.1 | 17.6 | 22.5 |
| Manufacturing | 28.4 | 24.8 | 21.3 | 25.1 |
| Construction | 34.9 | 29.4 | 23.2 | 25.3 |
| Transport | 31.9 | 26.7 | 14.8 | 20.9 |
| Communications | 28.8 | 23.5 | 5.4 | 14.1 |
| Electrical Power | 25.7 | 19.6 | 2.3 | 13.4 |
| Wholesale Trade | 38.3 | 33.8 | 24.1 | 26.2 |
| Retail Trade | 40.2 | 35.7 | 24.2 | 27.4 |
| Other Services | 34.2 | 29.3 | 23.8 | 25.8 |
| Structures | 24.2 | 19.7 | 16.3 | 19.0 |
| Machinery | 34.4 | 30.5 | 24.9 | 32.2 |
| Inventory | 38.1 | 33.1 | 18.7 | 18.7 |
| Land | 21.2 | 16.5 | 18.3 | 18.3 |
| *Aggregate* | *31.8* | *27.4* | *20.1* | *24.0* |

Source: International Tax Program, Institute of International Business, University of Toronto.

investment, we estimate the effective tax rate on capital, which is measured as the amount of taxes paid as a percentage of the return earned on a marginal investment project. The marginal project is one that earns a sufficiently high after-tax rate of return on investment that it covers the cost of financing (see Chen 2000).[5] For example, if a project earns a pre-tax rate of return on capital of 10 percent and if corporate income, capital and sales taxes on capital components account for 40 percent of profits, the after-tax rate of return on capital is 6 percent. If investors require a 6-percent return on investment or less, the project would be funded. The effective tax rate on capital incorporates corporate income taxes, including the treatment of depreciation, inventory and financing expenses, capital taxes and sales taxes on capital components.

Table 2 provides the effective tax rates on capital for large companies in nine major industries, excluding resource companies, and four major assets for Canada in 2003 and 2008. It also compares the effective tax rates on capital with 2003 estimates for similar investments in the United States, where we have taken into account the impact of accelerated depreciation that was introduced recently.[6] In

5 Specifically, the cost of capital, in the absence of taxes, is estimated as the weighted average of the cost of debt and equity finance, adjusted for inflation and risk. The before-tax rate of return is equal to the cost of capital adjusted for corporate income taxes on profits, tax depreciation, inventory valuation for tax purposes, investment tax credits, sales taxes on capital components, capital taxes and deductions for nominal interest expenses (see Chen 2000). An alternative approach is compare effective tax rates on projects with a specified after-tax rate of return on capital that is well above the cost of funds because capital expenditures are large and lumpy. This approach puts more weight on the importance of differences in statutory tax rates in determining competitiveness. However, it is not possible to determine what would be a risk-adjusted rate of return on capital except by analyzing specific projects. What we do know is that no project would be chosen if the after-tax rate of return on capital is below the cost of capital.

6 The May 2003 legislative changes increase accelerated depreciation by allowing companies to expense 50 percent, rather than 30 percent, of capital investment of less than 20 years in life.

**Table 3: Impact of Recent Federal and Provincial Tax Changes on the Effective Tax Rates on Capital by Industry for 2008**

| | Effective Tax Rates as of 2003 | Federal Reduction in Capital Taxes Only | Federal and Provincial Tax Reductions as Legislated |
|---|---|---|---|
| | | (%) | |
| Forestry | 30.1 | 27.7 | 26.1 |
| Manufacturing | 28.4 | 26.2 | 24.8 |
| Construction | 34.9 | 32.6 | 29.4 |
| Transport | 31.9 | 28.9 | 26.7 |
| Communications | 28.8 | 26.1 | 23.5 |
| Electrical Power | 25.7 | 22.1 | 19.6 |
| Wholesale Trade | 38.3 | 36.8 | 33.8 |
| Retail Trade | 40.2 | 38.9 | 35.7 |
| Other Services | 34.2 | 32.0 | 29.0 |
| Structures | 24.2 | 22.0 | 19.7 |
| Machinery | 34.4 | 32.3 | 30.5 |
| Inventory | 38.1 | 36.0 | 33.1 |
| Land | 21.2 | 18.7 | 16.5 |
| *Aggregate* | *31.8* | *29.7* | *27.4** |

* If Ontario eliminates all of its capital tax and Alberta lowers its corporate income tax rate to 8 percent from 11.5 percent as planned, the effective tax rate on capital in Canada will be 24.6 percent (across all industries), in Ontario 23.1 percent and in Alberta 18.6 percent.

Source: International Tax Program, Institute of International Business, University of Toronto.

total, Canada's effective tax rate will decline to 27.4 percent by 2008 from 31.8 percent currently. If Ontario were to eliminate capital taxes and Alberta reduced the corporate income tax rate to 8 percent from 11.5 percent by 2008, the effective tax rate would be lowered to 24.6 percent, closer to that in the United States in 2003.

Surprisingly, and depressingly, business investment will remain more highly taxed in Canada than in the United States, even after the significant reductions in corporate taxes in the past several years, as well as those planned for the future. Canada's distinct advantage in having a lower statutory combined federal-provincial corporate income tax rate — 34.4 percent compared with the 39 percent combined federal-state rate in the United States — is more than offset by several factors (Chen and Mintz 2003). The United States provides fast write-offs for capital costs, including accelerated depreciation and last-in first-out inventory cost accounting. Only a few states levy capital taxes, and then at rates substantially below those in Canada.[7] Accelerated depreciation in the United States contributes to a 3.9-percentage point reduction in the effective tax rate on capital. Because accelerated depreciation could be ended by 2004, the U.S. effective tax rate could increase to 24 percent, roughly equivalent to the Canadian 2008 effective tax rate if Alberta and Ontario fully implement the intended reductions that have not been

7 The average capital-tax rates in the United States are 0.048 percent on depreciable assets, 0.067 percent on land and 0.01185 percent on inventory. This compares to the Canada-wide average capital-tax rate of 0.2 percent on each type of asset by 2008, with the federal capital tax entirely eliminated.

legislated. However, both Congress and the White House are considering measures to lighten the tax burden in the next several years.

Table 3 separates the impact of federal and provincial changes in effective tax rates on capital. The federal elimination of its general capital tax will reduce the effective rate on capital by about 2 percentage points. Other federal and provincial corporate tax changes will cut the effective tax rate by over 3 percentage points, and if Alberta and Ontario proceed with planned reductions, the effective tax rate will decline a further 3 percentage points. Thus, the actions of the provinces are critical in making Canada's corporate tax system more competitive.

Overall, the reduction in the effective tax rate on capital could boost capital stock substantially. Taking estimates of capital responsiveness to changes in effective tax rates, the elimination of the federal capital tax by 2008 is estimated to increase capital stock by $47 billion.[8] All federal and provincial tax cuts by 2008 will increase capital stock by $113 billion. The effects of greater capital investment will be an improvement in labour incomes through productivity gains, as well as encouraging greater adoption of new technologies. The gain in Canada's standard of living if all the federal and provincial cuts are implemented as promised by 2008 would be $9 billion annually.[9] If Ontario were to eliminate its capital tax and Alberta were to reduce its corporate income tax to 8 percent, the increase in capital stock and Canada's standard of living would be even larger. Further, the elimination of sales taxes on capital inputs in provinces with retail sales taxes would have a substantial impact on capital investment by reducing effective tax rates by a further 3 percentage points.

## *Provincial Comparisons*

We also provide a comparison of effective tax rates on capital by province, industry and asset type for large Canadian corporate investments, that is, corporations with more than $15 million in assets. Figure 1 provides the 2003 aggregate effective tax rate by province in Canada for the 10 provinces and the United States. The estimates include provincial variations in corporate income taxes, sales taxes on capital components, capital taxes, investment tax credits and other special write-offs, as well as the federal Atlantic investment tax credit that primarily benefits the Atlantic provinces.

At present, the highest effective tax rate on capital is in Saskatchewan, with 37.6 percent, and Manitoba, with 36.4 percent, followed by Ontario, at 32.5 percent. The lowest effective rates are in Newfoundland, with 21 percent, and Alberta, at 26 percent. Both Newfoundland and Alberta have relatively low corporate income

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8 Economic studies on capital investment estimate investment responses of existing companies and, in the case of industry or countrywide data, responses of new capital projects attracted from other countries. The calculation above is based on the mid-point of estimated impacts of tax-adjusted costs on capital stock as referenced above. The after-tax, risk-adjusted rate of return on capital is 3.6 percent, after adjusting for inflation. Total non-residential private capital stock held is estimated to be $1.5 trillion in Canada by 2004.

9 This is estimated as the efficiency gain from reducing tax distortions in the capital market (the tax rate times the change in capital stock) and, assuming a fixed ratio of capital to labour, the efficiency gain from increased labour demand multiplied by the distortions in labour markets (a tax rate of 40 percent (Mintz 2001)). A capital-labour ratio of 3 is assumed for these calculations.

**Figure 1: Provincial Aggregate Effective Tax Rates in Comparison with the United States, 2003**

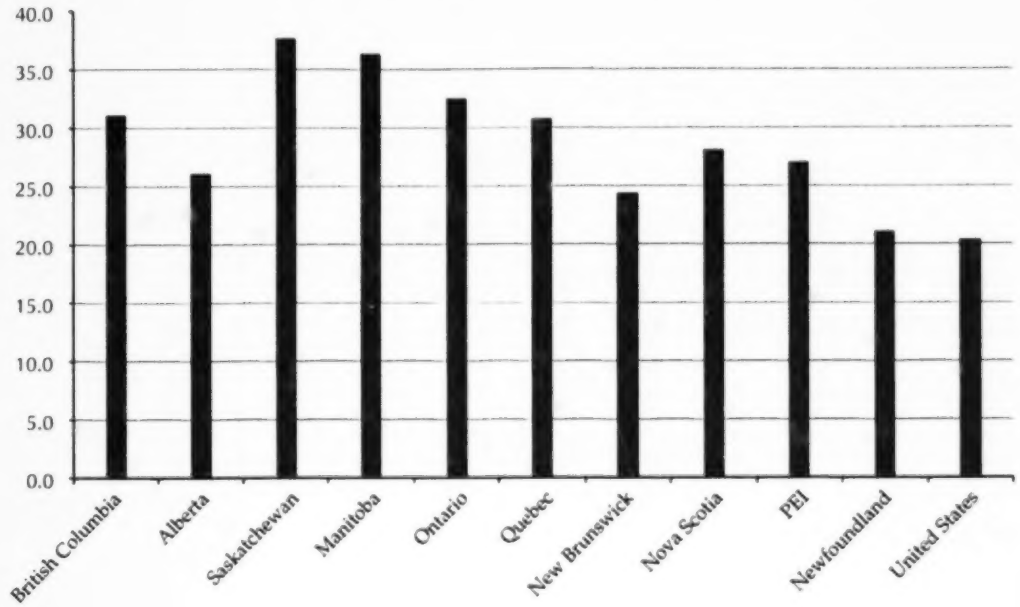


**Table 4: Effective Corporate Tax Rates on Capital for Large Corporations: All Provinces 2008**

| | BC | Alta | Sask | Man | Ont | PQ | NB | NS | PEI | NFLD |
|---|---|---|---|---|---|---|---|---|---|---|
| | | | | | (%) | | | | | |
| Forestry | 26.2 | 20.2 | 34.9 | 33.2 | 26.6 | 27.3 | 25.5 | 23.6 | 29.0 | 21.9 |
| Manufacturing | 24.2 | 20.7 | 23.9 | 31.5 | 24.3 | 27.5 | 14.7 | 12.4 | 10.8 | 2.2 |
| Construction | 29.7 | 24.2 | 34.4 | 36.1 | 29.3 | 29.9 | 22.7 | 21.2 | 26.4 | 15.2 |
| Transport | 26.3 | 18.6 | 34.2 | 32.9 | 27.0 | 25.6 | 23.8 | 21.8 | 29.6 | 20.2 |
| Communications | 22.0 | 17.3 | 30.8 | 28.9 | 22.6 | 24.0 | 22.4 | 20.4 | 24.7 | 19.0 |
| Electrical Power | 20.6 | 16.5 | 29.3 | 27.5 | 21.2 | 23.2 | 21.5 | 19.5 | 22.9 | 18.1 |
| Wholesale Trade | 33.4 | 27.4 | 34.0 | 39.5 | 32.1 | 32.9 | 30.6 | 29.5 | 31.1 | 24.2 |
| Retail Trade | 35.8 | 27.3 | 42.8 | 41.5 | 35.2 | 29.5 | 32.5 | 31.6 | 39.1 | 29.6 |
| Other Services | 28.8 | 22.3 | 36.2 | 34.8 | 28.6 | 28.1 | 27.1 | 25.8 | 31.8 | 24.1 |
| Structures | 18.8 | 17.4 | 25.3 | 26.1 | 19.0 | 23.8 | 18.8 | 16.9 | 15.7 | 13.5 |
| Machinery | 30.1 | 18.4 | 30.2 | 36.1 | 31.1 | 25.8 | 10.9 | 7.9 | 22.9 | 1.9 |
| Inventory | 32.9 | 31.0 | 40.0 | 39.9 | 31.4 | 36.2 | 36.1 | 35.4 | 32.5 | 29.3 |
| Land | 15.4 | 14.3 | 22.9 | 21.5 | 15.7 | 19.8 | 18.5 | 16.8 | 16.3 | 14.8 |
| *Aggregate* | *27.7* | *21.2** | *34.7* | *35.1* | *26.8*** | *27.9* | *21.0* | *21.1* | *23.4* | *16.8* |

* If Alberta lowers its corporate income tax rate to 8 percent from 11.5 percent by 2008, the aggregate effective tax rate would be 18.6 percent.

** If Ontario eliminates its capital tax by 2008, the aggregate effective tax rate on capital would be 23.1 percent.

Source: International Tax Program, Institute of International Business, University of Toronto.

taxes, no capital taxes and no sales taxes on capital components. As well, Newfoundland benefits from the federal Atlantic investment tax credit.

The planned reduction in corporate income and capital tax rates in Ontario, Nova Scotia and Manitoba, coupled with federal reductions in corporate taxes, will result in lower effective rates in all provinces by 2008 (Table 4). Manitoba and Saskatchewan will still have the highest tax burdens on large corporate investments. Ontario's effective tax rate will fall dramatically to 26.8 percent from 32.5 percent, though it will remain higher than that of most provinces.

If Ontario does eliminate its capital tax by 2008, as indicated in the last budget, the province would have an effective tax rate on capital of 23.1 percent, which would be well below Quebec's. The elimination of sales taxes on capital inputs would bring Ontario's effective tax rate down by an amount more than the elimination of capital taxes.

Clearly, if Ontario reverses its corporate income and capital tax cuts, as suggested by the Opposition Liberal Party, the province will have one of the highest tax burdens on corporate investment in Canada — considerably higher than the average rate in the United States.

## Why Not Cut Corporate Taxes Faster?

In an open economy like Canada, cutting corporate taxes is good for consumers because it enables businesses to lower prices. It is also good for workers who are paid more because additional capital increases labour productivity. Shareholders of corporations gain less because companies will not provide a higher rate of return to owners since businesses can obtain funding from international markets at a lower cost. Not only that, the revenue cost of corporate taxes is not large because greater economic activity increases tax revenue and businesses shift corporate income to low-tax-rate jurisdictions from higher ones.

Since our estimated gain in Canada's standard of living is close to $9 billion annually, why aren't governments cutting taxes more aggressively to access this economic advantage? And, with U.S. effective rates lower than Canada's even by 2008, why would governments wish to maintain a non-competitive corporate tax regime in Canada over most of this decade?

A typical answer is that Canadian governments need revenue to finance public goods and services that benefit Canadians and make Canada more competitive. While it is true that public expenditure on programs like health and education are beneficial, Canadian governments spend almost the same amount as a share of GDP as the does the U.S. on these programs. However, Canadian governments spend more on other services than U.S. governments as a share of GDP (Brown 2002). As well, even after taking into account subsidies for education, health, social programs, infrastructure and research and development, Canadian businesses are at a disadvantage compared to the United States (Mintz 2001).

A less common argument is that a phasing-in of corporate tax rates provides an additional boost to investment because businesses are able to deduct investment expenses when rates are currently high compared to future rates that are reduced on profits generated by the investment. However, while phasing in corporate rate cuts is appropriate to increase capital investment and reduce windfall gains to

owners of existing assets, it has generally been the practice to phase in cuts over two or three years, rather than five.

Although we believe further tax cuts are possible if governments constrain expenditures, we also point out that broad-based tax cuts could be compensated for by the elimination or reduction of some inefficient tax preferences for capital.

The federal Technical Committee on Business Taxation (1998) recommended the reduction of several preferences for capital investment, including the lifetime capital-gains exemption, depreciation, research and development costs, and tightening of rules affecting cross-border investments. While the federal government has addressed some areas, such as the elimination of differential corporate income tax rates on manufacturing, resource and service businesses and tightening the taxation of in-bound international investment, several specific provisions could be pursued in the interest of lowering corporate income tax and capital tax rates more quickly (Wilson 2003).

Similarly, many provinces have used special credits for investment that are questionable in design and effectiveness. Alberta has assiduously avoided using targeted preferences to stimulate activity by keeping tax bases broad and rates relatively low. Recently, Quebec announced that it is eliminating or reducing a voluminous number of incentives, including tax holidays and credits that were viewed as working ineffectively, although it chose, less wisely in our view, to defer a planned 50 percent reduction in capital tax rates. Most provinces could consider reducing or eliminating targeted tax credits, low small-business tax rates, labour-sponsored venture credit, and flow-through shares for the exploration and development of resources in the interest of paying for faster and even greater reductions in general corporate and capital taxes.

## Conclusions

Governments are moving in the right direction to reduce corporate taxes in their 2003 budgets. Ultimately, the great majority of Canadians are winners from reductions in corporate taxes because their incomes rise — by an estimated $9 billion from this round of cuts alone.

However, the reform is moving at a snail's pace in Canada. Quickening the process would provide gains in income and jobs for Canadians far sooner, as well as hastening an improvement in the competitiveness of the business sector. If governments have insufficient room to cut taxes now, they should constrain expenditures, or remove ineffective corporate tax incentives, to make broad-based corporate tax cuts affordable — not by 2008, but by the end of 2005 at the latest.

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